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2d Session

HOUSE OF REPRESENTATIVES

STATEMENTS PRESENTED AT THE HEARINGS

ON

THE IMPACT OF THE GRAMM-RUDMAN-HOLLINGS LAW (INCLUDING A LOOK AT THE CONDITION OF THE NATION'S ECONOMY)

BEFORE THE

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

JULY 23, 1986

ORIGINAL

AND ON

THE TRIGGERING MECHANISM OF THE GRAMM-RUDMAN-HOLLINGS LAW

BEFORE THE

HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

JULY 24, 1986

NINETY-NINTH CONGRESS

SECOND SESSION

JULY 1986

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PREFACE

On July 23 and 24, 1986, the Committee on Government Operations held hearings focusing on the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings). The first day of hearings, held by the committee's Legislation and National Security Subcommittee, addressed the economic factors and indicators that play a major role in the activation of the law's deficit reduction trigger action. Testimony was received on this issue from three of the Nation's leading private sector economists.

On July 24, 1986, the full committee received testimony from three of the Federal officials responsible for implementation of Gramm-Rudman-Hollings. The full committee hearing focused on how the law would operate in the wake of the recent Supreme Court decision in *Bowsher* v. *Synar* striking down the key "trigger" provision of the statute.

Following is the text of prepared statements presented during the two days of hearings:

Wednesday, July 23, 1986

Lawrence Chimerine, Chairman and Chief Economist, Chase Econometrics

Joseph W. Duncan, Chief Economist, The Dun & Bradstreet Corp.

Donald H. Straszheim, Chief Economist, Merrill Lynch

Thursday, July 24, 1986

Rep. William H. Gray, III, Chairman, Committee on the Budget

Charles A. Bowsher, Comptroller General of the United States, U.S. General Accounting Office

James C. Miller, III, Director, Office of Management and Budget

JACK BROOKS, Chairman,
Committee on Government Operations.

July 24, 1986.

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STATEMENTS PRESENTED AT THE HEARINGS ON THE IMPACT OF THE GRAMM-RUDMAN-HOLLINGS LAW (INCLUDING A LOOK AT THE CONDITION OF THE NATION'S ECONOMY) BEFORE THE LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE, JULY 23, 1986, AND ON THE TRIGGERING MECHANISM OF THE GRAMM-RUDMAN-HOLLINGS LAW BEFORE THE HOUSE COMMITTEE ON GOVERNMENT OPERATIONS, JULY 24, 1986

Committee on Government Operations

99th Congress

CHASE

Chase Econometrics

Statement By

Lawrence Chimerine, Ph.D.
Chairman and Chief Economist
Chase Econometrics
Bala Cynwyd, Pennsylvania

Presented to

Subcommittee on Legislation & National Security
of the
Committee on Government Operations
U.S. House of Representatives
Washington, D.C.

July 23, 1986

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My name is Lawrence Chimerine and I am the Chairman and Chief Economist of Chase Econometrics. I appreciate the opportunity to testify before the Legislation and National Security Congressional Subcommittee on the current state of the economy, expected Federal deficits, and how the provisions of the Gramm-Rudman-Hollings legislation will interact with the United States economy.

Summary

In sum, my views are as follows: (a) The slow and erratic economic growth that began in mid-1984 is continuing — if anything, the economy has actually deteriorated somewhat in recent months. Most significantly, there is no sign whatsoever of any acceleration in economic activity. (b) The economy has remained relatively weak despite optimistic forecasts because the stimulative impact of lower oil prices, declines in interest rates, and the weaker dollar have been less in magnitude, and later in coming, than many had expected, and because many other underlying forces are somewhat unfavorable. (c) At best, only a modest pickup in economic activity can be expected later this year. Furthermore, the risks are predominantly on the down side — either the absence of any turnaround in trade and/or some retrenchment in consumer spending would prevent any pickup at all, and could actually lead to a mild recession. (d) The outlook for 1987 is clouded with uncertainties related to tax reform and deficit reduction. The most likely outcome is a continuation of very modest economic growth at best, with the risks continuing to be predominantly on the down side. Again, even modest growth will require a substantial improvement in the trade deficit. (e) The Federal budget deficit outlook remains poor — I expect the deficit to be close to $220 billion in the current year, and approximately $190 billion in FY87, unless additional spending cuts and/or tax increases are adopted. (f) The options currently available to policymakers are limited as a result of the relative ineffectiveness of monetary policy at this point in the business cycle, and by the need to reduce enormous budget deficits for long-term economic stability. I would suggest, however, a far more gradual approach to reducing the deficit than implied by the current Gramm-Rudman-Hollings (GRH) targets, a further easing in monetary policy, and adoption of a tax reform package that would be less unfavorable for the short term.

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July 23, 1986

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Current Economic Situation

The recovery which began near the end of 1982 is now more than three and one-half years old -- this makes this recovery period one of the longest on record. However, the health of the economy has nonetheless been overstated because of a lack of understanding of many aspects of the recent economic situation. These include the following:

1. There have been two very distinctly different parts of the recovery period. The first eighteen months (or all of the 1983 and the first half of 1984) was characterized by extremely rapid growth (over 7% at an annual rate as measured by real GNP). However, the two year period since that time has witnessed a dramatic deceleration in the rate of growth to an extremely sluggish 2% rate--this is well below the historical average, so that only marginal additional progress at best has been made toward completing the recovery process. This is best illustrated by the fact that unemployment, capacity utilization and other measures of economic performance have shown no additional improvement since mid-1984. And, because of the dramatic slowdown since mid-1984, growth during this recovery in total is now below the rate experienced in most other postwar recovery periods.

2. This period of extremely slow growth has taken place even though the level of economic conditions has not been satisfactory. This reflects the fact that the 1981-82 recession followed closely on the heels of a previous recession, so that economic conditions were extremely depressed when this recovery period began. Therefore, virtually all measures of economic performance are still unacceptable. For example, the 7% unemployment rate that has prevailed during the last two years is obviously a significant improvement compared to the near 11% rate of late 1982, but it is still much higher than at anytime in the postwar period prior to the 1980s with the exception of a few months during the 1974-75 recession.

3. The performance of the economy during the past several years has been highly uneven, with many sectors still mired in recessionary conditions. This has created major industry and geographic differences which are causing severe hardships in many areas.

In sum, the performance of the economy in recent years, at least with respect to real economic growth, has been vastly overstated -- the recovery in total has not been particularly strong and is far from complete; we have experienced only marginal additional progress in completing the recovery process during the past two years; and the economy is still operating at highly unsatisfactory levels by historical standards.

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Despite numerous forecasts that a major pickup was likely during 1986, based on declines in interest rates, the dollar and oil prices, as well as low inventory/sales ratios and other apparently favorable factors, the economy remains mired in this process of slow and erratic growth referred to above. If anything, the economy appears to have completely stagnated in recent months, even though it now appears that economic growth (as measured by GNP) was still close to 2% in the first half. **First,** GNP during the first half has been bolstered by strong growth in real consumption expenditures, which may actually be overstating the strength in consumer spending. This reflects: **(a)** a weaker pattern for chain store sales than has been indicated by the retail sales reports, **(b)** a temporary spurt in auto sales due to the latest round of low interest rate financing, **(c)** a sharp increase in expenditures for brokerage commissions and other financial transactions which are more related to saving and investment than to ongoing consumer spending, and **(d)** the likelihood that recent price indexes are understating inflation and thus exaggerating real expenditures. Furthermore, gains in wages and salaries have decelerated further from the already sluggish rate during most of 1985 -- this implies that once the favorable effects of lower oil and food prices have passed, real wages will flatten out again. The dramatic slowdown in income growth, especially wages and salaries, is perhaps the most significant development that has taken place in recent years. It reflects not only continued downward pressure on wages in many industries, but a significant shift in the job mix away from high-paying, high-productivity occupations and industries into those with significantly lower wages. This is critical because, in the longer run, income growth is by far the most important determinant of consumer spending and thus living standards. And, unless the recent spending data are revised downward, it appears that most of the added purchasing power from lower oil prices has already been spent because the saving rate is now only slightly above where it was at the start of the year. Consumer spending is also likely to be held down by the reluctance of consumers to increase their already high debt burdens further despite lower interest rates -- higher delinquency rates may also cause credit grantors to be more cautious in extending credit to consumers. **Second,** the GNP data are inconsistent with other economic data (especially industrial production) which indicate a much more sluggish picture. This is reinforced by still declining commodity prices, by the weakness in wage income and profits, and by weak loan demand. **Third,** orders remained very weak in June, and reports from the field indicate little or no improvement thus far in July. The weakness is relatively widespread, with only appliances and commercial aircraft having experienced any meaningful increases -- backlogs are thus still relatively low in most industries.

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The sluggishness has continued despite numerous forecasts that a major acceleration would take place during 1986 because of declines in interest rates, the dollar, and oil prices, and other apparently favorable factors. However, the economy has not picked up for the following reasons:

1. The sharp decline in interest rates that has occurred since late 1984 has had only a small stimulative effect on the economy thus far, since real interest rates were extraordinarily high when these declines began (so that the early portion of the decline had little effect on economic activity). Thus, in effect, rate declines were necessary just to keep the economy in the same place, and in great part have been caused by the weak economy. The only noticeable effect of the decline in rates thus far has been on the housing industry -- real interest rates for industrial companies are still so high that there has been virtually no impact of recent declines in nominal rates on capital spending plans or on inventory policies. The impact of declining interest rates is also being limited by the age of the recovery, the winding down of previously available pent-up demands, and already high debt burdens, which have reduced the willingness of both corporations and households to incur additional debt. Thus, the Fed is in great part pushing on a string.

2. The economy has not yet experienced any significant benefits from the sharp decline in the value of the dollar. First, the decline which took place during 1985 had little or no effect on U.S. competitiveness in world markets, since it primarily squeezed what had been enormous profit margins of foreign companies selling in U.S. markets. Only in the last few months have prices of imported products begun to rise -- as is well known, it will take many months before these price changes begin to affect real trade flows. While these prices increases will eventually slow import penetration somewhat, the impact will be limited by the fact that many imported goods have no domestically produced counterparts, by the perception that some have higher quality than comparable domestically produced products, and by the increased familiarity of American citizens with foreign produced goods. Second, recent increases in imports, and softness in exports, to some extent reflect the impact of earlier oursourcing decisions as many new overseas plants become fully operational. Third, the U.S. trade deficit with Canada, Latin America and the developing countries in the Far East, continues to grow, in part because of weak economic conditions and debt problems in some of those countries, and in part because the currencies of most of those countries have not appreciated relative to the U.S. dollar. Fourth, the sharp decline in the price of oil has caused cutbacks in U.S. oil production -- this is already beginning to lead to increases in the volume of imported oil. Furthermore, most OPEC

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countries and other major oil exporters are beginning to slow their imports from the United States and other countries because of the impact of declining oil prices on their already poor current account positions. Finally, domestic demand is still weak in much of Europe and Japan.

3. The stimulative impact of lower oil prices on the economy will be modest, at best. In great part, this reflects the fact that the United States is a large prodcuer of oil (we produce about 70% of our own needs), so that the main benefit to the United States economy of declining oil prices comes from a decline in the price of imported oil. However, oil imports relative to GNP have fallen sharply since the early 1970s (by more than 50%), reflecting the fact that we consume far less energy relative to the size of the economy than we did then, that oil now constitutes a smaller fraction of our total energy consumption than at that time, and that we produce a larger fraction of our internal needs ourselves. The negative effects of lower domestic oil prices on profits in the oil industry is already causing sharp cutbacks in employment, and in exploration and other investment (by $12 - $15 billion). These represent very sizable offsets to the gains to consumers, and profits to oil users, that will result from lower domestic oil prices. Furthermore, because of already large current account deficits, most OPEC countries will reduce their imports of military and manufactured goods from the United States and other countries, which will offset part of the favorable effects of the lower cost of imported oil (as mentioned earlier).

4. In my view, the stock market boom in late 1985 and early 1986 does not reflect either current or expected economic strength — in fact, the rise in stock prices is more accurately a sign of weakness, since it largely reflects the sharp decline in interest rates, which in turn is a direct result of the sluggish economy. In effect, what has happened is that the substantial increase in liquidity that has been pumped into the economy by the Federal Reserve has gone into financial assets rather than fixed assets, reflecting the lack of viable fixed investments due in part to overcapacity, overbuilding, etc. Thus, many companies have found it more attractive to buy up their own stock, or someone elses, rather than making investments in plant and equipment. Furthermore, the sharp increase in the value of financial assets held by consumers is also vastly overrated as an economic stimulant, since: (a) ownership of financial assets is concentrated among relatively high income families with a relatively low marginal propensity to consume; (b) most individuals cannot gain access to these funds because they are tied up in pension accounts; and (c) many of those who have experienced capital gains have rolled them over rather than used them to finance consumption. In addition, household debt has risen dramatically during this period, with a far more widespread distribution across the population.

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5. Many forecasters had predicted an inventory-led acceleration in economic growth in 1986, reflecting the relatively low inventory/sales ratios which prevailed at the end of 1985. However, inventory/sales ratios have not been low because goods have been jumping off the shelves -- they have been deliberately reduced by manufacturers and retailers because of: (a) extremely high real interest rates; (b) large excess capacity; (c) relatively short lead times; (d) the still declining prices of many finished goods and commodities, and the uncertain price outlook; (e) the uncertain sales outlook; and (f) weakness in profits. The downsizing of desired inventory levels has in fact continued during 1986, so that at best, inventories are a neutral to somewhat negative factor in the economic situation.

6. Some forecasters also predicted a surge in the economy as a result of sharp increases in the basic money supply during the last 18 months. However, there is currently almost no relationship between M1 and economic activity, reflecting: (a) continued increases in import penetration, which increases the demand for credit and the money supply without increasing domestic output; (b) declining interest rates, which have reduced the opportunity costs of holding interest free or low interest deposits; and (c) concerns regarding the safety of deposits at various thrifts and other financial institutions, which has caused a shift of savings into M1 types of deposits.

The current economic situation can be summarized as follows: most of manufacturing is experiencing mild recessionary conditions, agriculture and energy are experiencing more severe recessionary conditions, and the housing and financial sectors appear relatively strong. And there is little or no meaningful evidence that any pickup in overall activity is on the horizon.

Major Forecast Assumptions

The outlook for the remainder of this year and 1987 will be affected by a number of key policy and other assumptions:

1. **Deficit Reduction:** The deficit outlook remains very uncertain. The "status quo" deficit outlook is not as favorable as earlier government reports suggested, reflecting the still high cost of farm programs, the likelihood that defense spending will exceed current targets unless appropriations are cut back further, the fact that tax revenues are lagging behind expectations because of weaker-than-expected economic growth, and because the decline in oil prices is actually worsening the deficit somewhat. The Congressional budget resolution for 1987 also substantially understates the likely deficit for these reasons. I assume that about $25

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billion of spending cuts (mostly in defense programs) will be adopted. The alternatives of much larger budget actions (either through the budget process or through automatic spending cuts), or even smaller cuts, still cannot be ruled out, however -- either would have a significantly different impact on economic activity in 1987. (The budget situation will be discussed further below.)

2. **Tax Reform:** While the impact of tax reform on the economy will depend on the provisions of the final bill, including the specific tax code changes, tax rates, effective dates and grandfathering provisions, it seems quite clear that tax reform could significantly depress the economy in the short run. This reflects the following: **(a)** It will likely change the tax structure very dramatically -- many corporations (and individuals) would find a very sharp change in their tax liabilities and/or, in the demand for their products. This is likely to cause some caution in making many new commitments, although some may be accelerated (i.e., taking of capital gains) to beat unfavorable changes in the tax code. **(b)** The bill will probably raise taxes in the short term, primarily because many of the base-broadening changes would become effective January 1, 1987 (with some, such as the elimination of the investment tax credit, retroactive to sometime in 1986), while the rate reductions could become effective on July 1, 1987. **(c)** The changes will dramatically weaken the tax advantages for many types of construction, as well as the incentives for investment. Since these sectors of the economy are already quite weak, changing the tax provisions so sharply will cause new activity in those sectors to decline even further. **(d)** The "winners" in the business sector (i.e., those which benefit from the reduction in corporate tax rates) are generally less capital intensive than the likely "losers" -- it will probably take longer for them to implement new programs than for those who are hurt to cut back (this is similar to the timing problems now being experienced as a result of oil price declines).

The economic impact of tax reform will also depend on whether it is effectively coordinated with deficit reduction -- I am assuming that the increase in revenues in 1987 which could result from tax reform will be used to help reduce the budget deficit. If in fact the tax reform bill does raise taxes significantly in 1987 on top of other tax increases and spending cuts which are designed to achieve the GRH deficit target, the combined effect would be an extremely restrictive fiscal policy that could dramatically weaken the economy in late 1986 and/or 1987.

3. **Interest Rates:** I believe that rates will move lower during the rest of the year, with the Fed adopting at least one more easing move as the economic statistics stay soft during the remainder of the summer.

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4. **Oil Prices:** Spot crude oil prices have moved up significantly during the last several days due to: (a) a small pickup in demand, reflecting fuel substitution and higher gasoline consumption; (b) continued declines in oil inventories; and (c) cutbacks in production in the United States and some other countries. While crude prices are likely to remain extremely volatile, I believe that oil prices will eventually stabilize in the mid- to upper teens -- this expectation is in part based on the assumption that a production sharing agreement will be reached among the OPEC countries -- so that most of the effect of lower oil prices on refined product prices, real incomes, etc., has already taken place.

The Outlook for the Second Half of 1986 & 1987

The factors discussed earlier will continue to hold down economic growth during the second half of this year, as will the following:

1. Capital spending will not contribute significantly to economic growth -- this is indicated by recent plant and equipment surveys, appropriation rates, orders, etc. The sluggishness in capital spending reflects: (a) unusually low capacity utilization rates at this stage of the economic expansion, so that there is very little capacity-oriented spending taking place; (b) the downward trend which is now developing in construction of office buildings, hotels, and other commercial structures, reflecting high and rising vacancy rates; (c) continued cutbacks in exploration and other capital expenditures by the energy industry; (d) little or no growth in orders and sales; and (e) the uncertainties being created by tax reform which is slowing the commitment process. In addition, still high real interest rates for industrial companies and weak profits and cash flow have kept the financial environment for capital spending somewhat unfavorable.

2. The housing boom is now peaking. Single-family housing starts are likely to edge down during the remainder of the year, since mortgage rates have at least temporarily bottomed out (and have actually risen somewhat in response to strong demand for refinancing); the demographics are becoming less favorable; housing prices are rising more sharply, undermining affordability somewhat; the bubble created earlier as many families jumped into the market is subsiding; and income growth is sluggish. Multifamily housing starts will likely drop off even more sharply, reflecting less availability of tax-exempt financing; extremely high vacancy rates (especially in the condominium market); and the impact of tax reform. Thus, at least the direct contribution of housing construction to GNP growth will taper off after the next several months.

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3. Government spending will grow very slowly at best. Cutbacks at the Federal level, resulting from deficit-reduction programs, and at many state and municipal governments, in response to tighter budget conditions, will hold growth in total government expenditures in real terms to less than a 2.0% annual rate during the rest of this year.

Thus, the cutbacks that are now developing in commercial construction, continued weak capital spending, and slower growth in consumer spending in response to anemic income growth, low savings and high debt burdens, will hold down domestic final demand. Furthermore, as mentioned earlier, it is unlikely that any inventory building will take place. Thus, it is now clear that even a modest pickup in economic growth during the remainder of this year will require an improvement in the trade deficit, both to directly stimulate production as well as to help speed up income gains. While a sustainable decline has not yet begun, increasing reports of rising export orders, continued delays in new outsourcing and foreign investment plans by U.S. companies, and increases in the prices of many imported goods in recent months, continue to suggest that some improvement will in fact occur later this year. The turnaround in the deficit will be very gradual, however, in view of still extremely sluggish domestic demand in Japan and most European countries; the still highly overvalued dollar relative to the currencies of most LDCs; likely increases in the volume of imported oil; and lower exports to many oil producing countries.

On balance, therefore, while I believe that the second half of the year will be somewhat stronger than the first half, reflecting an improvement in the trade deficit, the pickup will not begin until late summer. It should be noted that even with an improvement in the trade deficit, economic growth during the second half will only be in the 2.5% to 3.0% range, still unacceptably low in view of the large amount of idle resources throughout the economy. Furthermore, most of the risks appear to be on the downside -- these include the possibility that the trade deficit will remain at current or even higher levels in real terms; that consumers begin to retrench in view of the low savings and high debt burdens that currently prevail; and that the anticipated effects of tax reform are greater than now expected.

The outlook for the economy in 1987 will be primarily determined by the following:

1. The lagged effects of changes in exchange rates will have an increasingly favorable effect on the trade deficit as we move through 1987. Thus, trade will make a significant contribution to economic growth on an annual basis for the first time since the early 1980s.

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2. Declines in real interest rates which will take place during the second half of this year will have at least a modestly favorable effect on investment during 1987. These declines will result from an assumed additional round of Fed easing later this summer (including an expected reduction in the discount rate), as well as the modest acceleration in inflation we expect.

These factors will, however, be at least partially offset by the negative short-term effects of tax reform and deficit reduction (as discussed earlier). Thus, economic growth is likely to continue in the 2.5% range, although the outlook will remain somewhat uncertain until fiscal policy issues are resolved. I view the risks again to be predominantly on the downside in 1987, so even slower growth is a distinct possibility.

Table 1 summarizes my forecast for the key economic indicators for this period:

Table 1
Forecast Summary Table
(percent change)

	1983	1984	1985	1986	1987
Real GNP	-2.5	6.5	2.2	2.1	2.4
Industrial Production	5.9	11.6	2.2	0.4	3.0
Real Consumption	4.6	4.4	3.3	3.3	2.7
Real Fixed Investment	-1.8	19.5	9.7	-1.0	0.0
Consumer Price Index	3.2	4.3	3.5	2.0	3.5
GNP Deflator	3.7	4.2	3.3	2.5	3.2
Pre-Tax Profits	20.9	15.9	-5.2	0.0	12.2
Unemployment Rate (%)	9.6	7.5	7.2	7.1	7.1
Prime Rate (%)	10.8	12.0	9.9	8.2	8.0
Auto Sales (million)	9.2	10.4	11.1	10.8	10.7
Housing Starts (mil.)	1.7	1.77	1.74	1.87	1.68

It should be noted that the quarterly GNP pattern is likely to be extremely volatile during the rest of this year and 1987, reflecting erratic movements in the trade deficit;

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the precise timing of auto production cutbacks and incentive programs; the anticipatory and actual impacts of tax reform; the timing of budget cuts and/or tax increases; and the impact of possible revisions to earlier data. However, while GNP and/or other indicators may rise sharply in any one quarter, a sustained economic boom during the remainder of 1986 and 1987 is extremely unlikely, as discussed earlier. At best, very modest growth on average will take place, with a number of downward risks that could keep the economy even more sluggish -- as mentioned earlier, these include the possibility that the turnaround in trade will be weaker (and/or, come later) than now expected, that budget cuts and/or tax reform will be even more restrictive in the short term, or that consumers will attempt to rebuild savings (and cut debt) more quickly.

Why Such Slow Growth?

In my judgment, the extremely slow growth of the last two years, and that still to come, reflects the policy errors of recent years, primarily budget policies. These have been responsible for the high real interest rates, overvalued dollar, and imbalances and distortions which have caused the dramatic slowdown in economic growth. In fact, despite the sharp decline in nominal interest rates in recent years, real interest rates remain extremely high (especially in relation to the industrial deflation that has taken place); furthermore, virtually all of the decline in rates has occurred during periods of subpar growth. Because of the enormous Federal deficits, which are causing sharp increases in the Federal Debt/GNP ratio, interest rates have actually risen each time the economy has picked up during this period. In addition, the overvalued dollar directly reflects the upward pressure of budget deficits on U.S. interest rates. In effect, budget deficits have produced large trade deficits because of the need to attract foreign capital in order to help finance them. Furthermore, as pointed out earlier, the impact of declines in the dollar which are now taking place will not be as dramatic as the impact of the rise in the dollar in earlier years because of the asymetrical relationships already discussed, and because the long

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period during which the dollar was overvalued produced numerous decisions (including shifting of production overseas by many companies) which may never be reversed. The recovery in the last several years has also in great part been financed by an explosion in debt in all sectors of the economy, and has benefitted from the commercial construction boom -- these factors are unsustainable, and thus not only cannot continue to perpetuate economic growth, but are now contributing to the slowdown in the economy. Finally, the enormous imbalances in the system are not conducive to strong economic growth because the extreme weakness in some sectors (such as manufacturing and agriculture) are now dragging down other sectors of the economy, and as discussed earlier, are causing a dramatic slowdown in income growth.

The Deficit Outlook and GRH

The Federal budget deficit continues to worsen despite some apparently favorable developments -- higher-than-projected defense and agricultural spending, along with weaker-than-expected revenues due to slow economic growth, are primarily responsible. Thus, even with the first round of GRH cuts, the unified deficit for the current fiscal year will be in the $215 to $220 billion range. (A lower figure may be eventually reported because the retroactive elimination of the investment tax credit will generate higher corporate tax liabilities in 1986.) In my view, a realistic estimate of the FY87 deficit is now near $190 billion when the 1987 budget resolution is adjusted for continued slower-than-expected growth, and more realistic estimates of agricultural and other spending. It is thus now apparent that larger spending cuts and/or tax increases than policymakers previously expected will be necessary to achieve the GRH target for FY87. However, the GRH approach is very dangerous in the current environment, because it would cause additional spending cuts to compensate for the added deficit caused by slower economic growth -- this would only slow the economy further, and in effect, would circumvent the automatic stabilizers that have served the economy so well for many years. Furthermore, many of the spending cuts in the budget resolution represent accounting changes which are

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likely to widen the deficit in future years. Deficits beyond FY87 will also be increased if tax reform becomes integrated into the budget process, because the likely bulge in tax revenues resulting from tax reform in FY87 will be reversed in succeeding years. Finally, it will be difficult to find additional politically and socially acceptable spending cuts in future years. Thus, sizable tax increases will almost certainly be necessary if the deficit is to be reduced further in the outer years.

Policy Suggestions

In my judgment, there is very little that economic policymakers can do to help speed the economy in the near term; this reflects the following: (a) As implied earlier, the Federal Reserve is essentially pushing on a string because of the already high debt burdens, excess capacity and overbuilding which characterize the economy. This limits the impact of declines in interest rates on economic growth at this point in the cycle. The Fed's flexibility has also been reduced by the explosion in money growth in recent years. (b) It is essential that deficits be reduced on a long-term basis, to reverse the current upward trend in the Federal Debt/GNP ratio. If that trend is not reversed, it will mean continued high real interest rates on a long-term basis and/or a continued overvalued dollar and thus poor competitiveness in world markets, and/or a pickup in inflation later in this decade -- any or all of these would cause long-term economic stagnation. Furthermore, lower deficits are also necessary to slow the explosion in interest payments, which will feed on itself and produce even higher deficits in the outer years if it is not stopped. Finally, lower deficits are necessary to prevent a sharp increase in the tax burden on future generations. Thus, for all of these reasons, it would not be practical to cut taxes and/or raise spending to stimulate the economy in the short term -- thus, fiscal policy must be at least somewhat restrictive in the near term.

Lawrence Chimerine

Chase Econometrics
July 23, 1986

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While economic policy cannot lead to faster economic growth, it is nonetheless essential that some policy actions be taken to prevent the economy from sliding into a serious recession. These actions include the following: (a) I strongly recommend sizable additional reductions in interest rates -- such declines should help to prevent further deterioration in capital spending and may bolster confidence somewhat, thus generating at least a small amount of added stimulus. (b) Because of the poor short-term deficit outlook, the target for FY87 in the GRH legislation should be raised -- otherwise, at least $50 billion worth of spending cuts and/or tax increases will be necessary to achieve the target. Cuts of that magnitude would imply a tremendously restrictive fisal policy which would have a severely depressing effect on the economy in the short term. I would suggest cuts of less than one-half that amount at most. In effect, the Administration and the Congress missed a golden opportunity to cut the deficits in earlier years when the economy was growing more rapidly -- a more realistic approach in the current circumstance would be to aim for deficit reduction of approximately $20 billion per year, with the aim of reducing the deficit to about $100 billion by the early 1990s. I also strongly believe that any reductions in expenditures should be accomplished by converting many current entitlement programs into means-tested programs, rather than implementing across-the-board spending cuts. In addition, some tax increases will eventually be necessary -- I urge that regressive tax increases be avoided in view of the dramatic shift in the distribution of income and in the distribution of the tax burden which has already taken place in recent years. (c) As mentioned earlier, tax reform is already causing some commitments to be postponed, and the anticipatory and actual dampening effects of tax reform may continue to hold down economic growth later this year and in 1987. I believe that these effects could be minimized if the following were implemented: i) Some of the major changes, such as the elimination of the investment tax credit and the changes in tax rates, should be phased-in over several years rather than all at once. ii) Grandfathering of existing provisions to reduce the risk of sizable losses on currently held assets should be considered. iii) The effective dates should be changed so as to avoid a substantial tax increase in 1987.

Lawrence Chimerine

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July 23, 1986

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The Economic Outlook and Gramm-Rudman-Hollings

Prepared for the
House Government Operations Committee
July 23, 1986

Presented by Joseph W. Duncan
Chief Economist, The Dun & Bradstreet Corp.

Introduction

Mr. Chairman, Committee members, and fellow participants, I am honored to have been invited to testify on the important issues of the general condition of the national economy and the relationship between the economic outlook and critical Congressional actions on fiscal policy.

The subject of these hearings is very complex. The economic outlook will be determined, in part, by decisions made by the Congress in the next few months--decisions about tax reform, federal spending, and general tax policy. Equally important, the pattern of economic activity will determine the level of tax revenues, the needs for certain expenditures, and the triggers for actions required by Gramm-Rudman-Hollings. I would like to point out that the economic outlook which I am presenting to you today is based on a set of assumptions regarding future Congressional actions. A significant deviation from the assumed actions discussed here would, of course, have an impact on the economic forecast presented in this testimony. Given this caveat, my testimony will employ the following approach in order to break into this complicated issue.

First, I will briefly outline my key assumptions about Congressional actions in the next few weeks. Those assumptions condition my outlook for economic trends in the next few quarters. Second, I will cite data from Dun & Bradstreet that characterize the current state of the domestic economy. My general economic outlook follows from my interpretation of those statistics and other information. Third, I will briefly review the implications for Gramm-Rudman-Hollings and the interactions between tax reform and deficit reduction.

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Finally, I will conclude with some suggestions about the crucial role of "expectations" on the evolving outlook.

First, however, let me highlight my most important points about the interaction of economic trends and Congressional decisions.

Interactions of Tax Reform and Deficit Reduction

In the forecast that I present today there is a difficult dilemma from the point of view of Gramm-Rudman-Hollings. A basic assumption of my forecast (as outlined below) is that the effective dates for both tax reductions and new taxes will be January 1, 1987--a move dictated in part by the fact that the economy is already sluggish and is unlikely to regain strength until the stimulus of the improved tax policy is in effect. However, moving up the effective date for the tax reductions also costs revenue and the deficit becomes wider.

Current procedures call for estimates in October. If the Tax Reform bill is signed by Labor Day--the current target date--this negative revenue impact will be anticipated to some extent. However, since most revenue forecasts assume that the changes occur in a static world, it is likely that the true impact of the early effective dates will not be anticipated correctly. For example, the early availability of the tax benefits could stimulate the economy more than anticipated, which would yield higher revenue than projected. Alternatively, early definition of the ground rules could redirect investment and consumption from tax base areas, resulting in lower revenue than forecast. This could lead to significant errors in defining the targets for Gramm-Rudman-Hollings.

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The Economic Outlook

Current economic statistics indicate that the pace of activity in the domestic economy is sluggish. For example, recently released statistics show the following pattern:

Variable	4th Q-85	1st Q-86	2nd Q-86
Gross National Product	2.1%	3.8%	1.1%
Final Sales to Domestic Purchasers	4.7%	-1.8%	5.5%
Consumer Expenditures	1.7%	3.6%	5.9%

The pattern is significantly below the growth rate of 4% that was called for the Economic Report of the President at the beginning of the year. Of great significance is the fact that few economic indicators show any significant evidence of strength.

Dun & Bradstreet Data

Despite signs of weakness, it is important to note that several indicators of economic activity that we collect at The Dun & Bradstreet Corporation suggest some important underlying strengths. For example, quarterly surveys of the views of business owners show that their overall optimism about the future of the economy remains high, especially since the current business cycle has been on a positive track for three and one-half years.

Chart 1 summarizes data from the Dun & Bradstreet Quarterly Expectations Survey. You will note that business people's expectations generally coincide with economists' view of business cycles. Of particular importance to the current discussion is the relationship between business expectations and their actual experience. Currently, actual performance is falling significantly below expected performance, a pattern which emerged in late 1984 and persisted through the beginning of this year. The only other time when actual performance lagged expectations significantly during a business expansion was in 1967 and early 1968. This leads to my view that while we have the potential for sustained economic growth that

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can equal the record of the 1960's, lags in performance are threatening that potential.

Other indicators from Dun & Bradstreet statistics have not shown any significant deterioration in the economy. For example, business failures in the first six months of 1986 were up 8.1% compared to 9.6% for all of 1985. Clearly there are some difficulties in particular sectors, with mining and services being the areas with the greatest increases in business failures. The trend in mining is attributable to difficulties with petroleum exploration and drilling. In contrast, the trend in services is attributable to the sharp growth in new business activity in the service sector in recent years.

Development of new firms is measured by the Dun & Bradstreet series on business starts. For the first six months of 1986 business starts were up 8.4%, with nearly 15% growth in finance, insurance and real estate and 9% in services. Earlier, services were growing more rapidly; however, the large number of new competitors is slowing down the formation of new companies in the sector.

Another indicator of new business activity is data on new incorporations. While some new incorporations represent legal activities to create tax shelters and to limit liability, they have historically been an indicator of the creation of new enterprises. Dun & Bradstreet's series on new incorporations showed an increase of 5.3% in 1985 and an increase of 8.7% in the first four months of 1986.

This surge in entrepreneurial activity is the backbone of current strength of the U.S. economy. Our surveys show that nearly two-thirds of the jobs added in the economy are in firms whose total employment in all locations is less than 100 employees. Our most recent survey of the employment outlook (January 1986) indicated that approximately 3 million new jobs would be added in the U.S. economy in 1986. It is particularly interesting to note that despite the weaknesses shown by other economic indicators, the Bureau of Labor Statistics data for June show that we have created 3 million new jobs in the past 12 months. Finally, with respect to Dun & Bradstreet data, I would call your attention to building permits--a leading indicator of future construction--which were up a strong 10% in 1985, despite difficulties in some areas with high vacancy rates.

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Consumer Expectations

The final economic indicator that I will call to your attention is the Consumer Sentiment Survey published by the University of Michigan. The consumer, like the business people discussed above, remains strongly optimistic about the current health of the economy and the future outlook. The most recent data from the Consumer Sentiment Survey are from the month of June, 1986. The index stands at 99.3, very close to the record level of 101 reported for the month of March, 1984, at the beginning of the current business cycle recovery.

A recent release (July 18, 1986) from the University of Michigan Survey Research Center noted:

"In the second quarter 1986 survey, the Index of Consumer Sentiment was 96.8, up from 95.5 in the first quarter and 91.1 at the close of 1985. During the past thirteen quarters the Index has remained in the relatively narrow range of 91.1 to 99.5, the longest period of such high levels since the mid 1960's. Favorable attitudes toward buying conditions for homes were held by 85 percent of all families in the second quarter 1986 survey, the highest proportion ever recorded."

This view of current economic conditions is somewhat mixed. Our major macro indicators are sluggish, yet there is evidence that business and consumer confidence remains strong.

Uncertainty About Tax Reform

How do we explain this dichotomy? I think that the most important new factor in economic behavior is the uncertainty that has been generated by the prospects for significant tax reform. Earlier this year, few analysts believed that tax reform could be achieved in the political environment of 1986. While the President was given credit for rescuing the tax reform movement in the House of Representatives, it appeared that political pressures were pulling in such diverse directions that a political consensus could not emerge. Given the skepticism about tax reform, many consumers and businesses began making decisions as though nothing was going to happen.

The emergence of the dramatic proposal from the Senate Finance Committee changed both the outlook of the analysts and the public mood. Today, many are awaiting final proposals before current purchases are completed

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and future investments are decided. It is uncertainty about the shape of tax reform combined with a sense of high probability that tax reform will occur that has dampened current economic performance.

In fact, a recent Dun & Bradstreet survey (May 1986) of 5,000 U.S. firms showed that most of the nation's business leaders believe that the proposed Senate tax bill would help the overall economy, but they are less optimistic about its impact on their specific businesses. Among the businesses surveyed by D&B, 62.4% said the current Senate tax proposal would be good for the economy, while 51.1% said it would be good for their businesses.

Assumptions about the Economic Outlook

The outlook for coming quarters, therefore, must recognize the current sluggishness and estimate the strength of future demand, especially in the investment area. My forecast involves the following key assumptions:

1. The effective dates of tax reform will be moved up to January 1, 1987. This action will be a result of the widespread recognition of the current sluggish state of the economy. A delay to July would simply prolong sluggishness.

2. My fiscal forecast is that the Gramm-Rudman-Hollings targets will be met. We will return to this point later in this testimony.

3. The stimulus of lower oil prices will be positive for the next several quarters, but the transaction price for long-term oil contracts will drift upward toward $18 per barrel.

4. The dollar will not decline significantly further, although there will be up and down movements of plus or minus 10% from current levels.

Based upon these assumptions I project the pattern of economic activity for 1987 and 1988 which is shown on the following page?

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Forecast of Gross National Product
(Dollar Amounts in Billions)

	Actual		Forecast		
	1984	1985	1986	1987	1988
Gross National Product Current Dollars	3774.7	3988.6	4201.5	4498.5	4803.9
Annual Rate of Change (%)*	6.5	5.7	5.3	7.1	6.8
Gross National Product 1982 Dollars	3492.0	3570.0	3673.6	3820.6	3923.2
Annual Rate of Change (%)*	11.0	2.2	2.9	4.0	2.7
GNP Deflator (1982=100)	108.1	111.7	114.4	117.8	122.5
GNP Inflation, Annual Rate of Change (%)*	4.2	3.3	2.1	3.5	4.2
Consumption Expenditure	2239.8	2313.0	2403.8	2477.7	2539.0
Annual Rate of Change (%)*	4.4	3.3	3.6	3.4	2.5
Business Fixed Investment	430.2	472.1	464.0	486.3	504.1
Annual Rate of Change (%)*	19.5	9.7	-0.5	3.5	3.7
Residential Fixed Investment	168.3	171.2	190.8	193.3	189.3
Annual Rate of Change (%)*	13.2	1.7	9.1	3.4	-2.0
Government Purchases	675.9	716.4	731.3	738.2	743.4
Annual Rate of Change (%)*	4.3	6.0	1.5	1.6	0.7
Chg. in Bus Inventories	62.6	5.7	17.1	41.6	35.7
Net Exports	-85.0	-108.4	-133.4	-116.4	-88.4

*seasonally adjusted

July 1986 - Economic Analysis Department
The Dun & Bradstreet Corporation

Note: Does not reflect July historical revisions.

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Gramm-Rudman-Hollings

From the point of view of these hearings the key question is, Will the Gramm-Rudman-Hollings targets be met? Alternatively, the question is, What are the probabilities that economic growth and/or lack of Congressional resolve operate to generate a deficit greater than that of the target of $144 billion specified for fiscal 1987?

In recognition of the uncertainties of making accurate revenue and spending estimates, Gramm-Rudman-Hollings permitted a $10 billion error in achieving the $144 billion target. Current estimates for fiscal 1987 suggest that the deficit will be larger than projected earlier this year. One current rule of thumb is that a decline of 1% in the rate of real economic growth would increase the deficit by $20 billion. While that is a rough estimate it is important to note that a decline in growth of only one half of one percent would cause the $10 billion error permitted by Gramm-Rudman-Hollings.

Econometric estimates, of course, suffer from the limitation that they do not provide for specific Congressional action. Triggering of the automatic provisions of Gramm-Rudman-Hollings would require a lack of budget reduction action by the Congress. Given that most members ran on a deficit reduction platform in 1984, it seems to me politically risky for Congress to "walk away from the issue." Thus, in the current political environment, it appears unlikely that the deficit forecast to be presented by October 5 (the deadline for Gramm-Rudman-Hollings) will exceed the $154 billion target.

A second feature of Gramm-Rudman-Hollings is the fact that if OMB or CBO would generate a forecast of two or more consecutive quarters of negative economic growth, the automatic spending cuts would be eliminated. Given the prospects of tax reform and expected stimulus from tax reform, it seems to me unlikely that an economic forecast would be generated by either OBM or CBO that offered immediate prospects of a recession in fiscal 1987.

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Statement by

Donald H. Straszheim

Chief Economist

Merrill Lynch

before the

Subcommittee on Legislation and National Security

of the Committee on Government Operations

U.S. House of Representatives

July 23, 1986

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We have significantly reduced our economic forecast for the second half of 1986. Though the decline in interest rates and oil prices earlier this year will continue to pay benefits, the long-awaited second-half rebound is not likely to materialize. Instead, we believe that the economy will slip sideways, with real GNP growth in the last two quarters of 1986 in the vicinity of +1.0% and -1.0% respectively. We do not as yet believe conditions are so weak as to anticipate a full-fledged recession.

The co-existing very strong and very weak areas portray an unusually uneven economy. Increasingly, the weak spots in the economy are contaminating the strong spots. Consumer spending and housing can no longer carry the economy forward. Manufacturing is sinking, with capacity utilization at 78% and headed lower. The problems of commercial construction, agriculture, energy and the other extractive industries are increasingly troublesome. Plant and equipment spending is dead in the water, while improvement on the trade front will be slow in coming.

Lack of economic growth is bad for corporate earnings, which will show little, if any, improvement in 1986. But interest rates will fall choppily—due to both the weak economy and further Fed easing.

The consensus view remains for a considerable pick-up in the second half. However, it is our sense that the consensus view is becoming more pessimistic, with more downward movement to come. Neither our forecast—nor others of which we are aware in the forecasting

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mainstream--satisfies the technical definition of recession, the shorthand version of which is two successive quarters of a negative growth rate.

Following are comments about conditions in the various sectors as well as comments on other particular issues.

CONSUMERS

Consumer spending will be markedly weaker in the second half of 1986 than in the first half, as households will be strained by sluggish income growth and high debt. Purchases are likely to rise at no more than a 1.5% annual rate, perhaps even edging down. That compares to about a 4.5% increase in the first half.

The leveling off of income growth during the last couple of months will begin to retard consumer spending in the second half of the year. And, real after-tax income will grow very little during the remainder of this year.

HOUSING

Housing starts are likely to weaken somewhat during the second half, but still come in at a respectable rate--not under 1.75 million. Multi-family starts are expected to suffer from the double negatives of over-building and tax reform. Even if housing activity did not deteriorate at all--but rather stayed flat at a high level--housing would contribute nothing to real growth.

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PLANT AND EQUIPMENT SPENDING

Business capital spending was not strong in the first half and will be down substantially in the second half, in both structures and equipment. Commercial construction is paying the price for over-building, while also being hit in the short run by tax reform. There are many negatives in the investment environment. Corporate cash flow is sputtering, tax reform means a business tax-hike, and capacity utilization in manufacturing stands at 78%--heading lower.

Capital spending has collapsed in the oil sector, and is weakening in the rest of manufacturing as well. Many service industries that are tied to the health of the industrial economy--like finance, transportation, communications, and business services--are also likely to trim their spending plans.

INVENTORIES

Business will become even more cautious in its inventory policy as the weakness in the economy spreads. Inventory building will not contribute anything at all to growth.

CORPORATE EARNINGS

A sideways economy will take its toll on corporate earnings in the second half of the year. For 1986 as a whole, S&P 500 earnings per share are likely to be essentially flat with 1985, while National Income Accounts after-tax corporate profits may be down as much as 10%. Conceptual differences between S&P 500 earnings and NIA profits account for this seemingly large discrepancy.

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INTEREST RATES

Interest rates are likely to fall significantly further during the remainder of the year, both in response to the weak economy itself and as a result of additional monetary policy ease from the Federal Reserve. Another discount rate cut is expected as the weakness in the economy becomes apparent. The yield on 13-week Treasury Bills is likely to fall toward 5.5%, with the yield on the 30-year Treasury Bond falling under 7.0%.

FOREIGN TRADE AND THE DOLLAR

The dollar will continue to decline against the currencies of most other industrialized nations—with the big exception of Canada. We anticipate a fall to about 150 Japanese Yen and 2.10 German Marks by autumn.

The trade statistics have done poorly so far this year—and are expected to remain sour during the second half despite the dollar decline over the last year. The key factor frustrating the improvement on trade is the fact that the dollar is down relatively little over the last 18 months against the currencies of a host of countries that are increasingly important U.S. trading partners.

FISCAL POLICY AND THE DEFICIT

Our forecast assumes that major tax-reform legislation will be enacted later this summer, resolving this area of uncertainty and splitting the difference between the House and Senate bills. However, no sooner will the ink be dry on this legislation than the economy's

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troubles will trigger debate on a possible fiscal policy response. Under the circumstances—a still large deficit and a new version of Gramm-Rudman—it is difficult to imagine a major counter-cyclical initiative.

Furthermore, the economy's performance is likely to fall below the assumptions that probably will be incorporated into federal budget estimates made by both the Adminstration and the Congressional Budget Office. By our estimates, the result will be a fiscal 1987 budget deficit of nearly $200 billion--almost as high as fiscal 1986's deficit anticipated to exceed $200 billion--utterly confounding intentions to reduce the deficit to $144 billion as specified by the Gramm-Rudman legislation.

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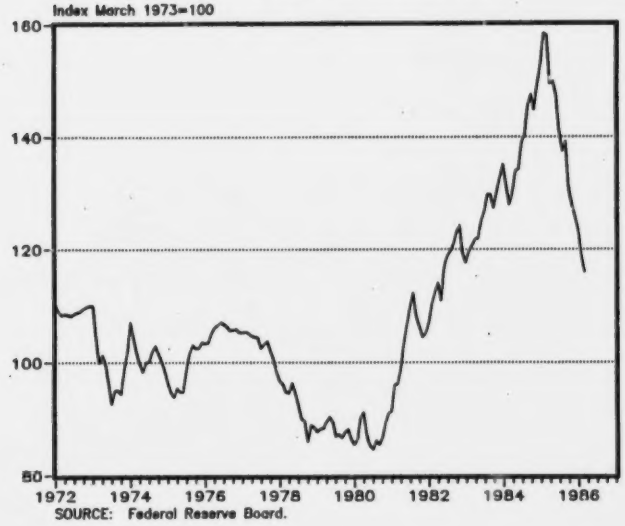
Exhibit A

TRADE-WEIGHTED VALUE OF THE DOLLAR



SOURCE: Federal Reserve Board.

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Exhibit 8

U.S. TRADE AND THE DOLLAR

FRB Basis		Import Basis		Export Basis	
Country	Weights	Country	Weights	Country	Weights
Germany	20.8	Japan	23.5	Canada	26.4
Japan	13.6	Canada	22.6	Japan	12.7
France	13.1	Germany	6.9	Mexico	7.6
England	11.9	Mexico	6.3	England	6.3
Canada	9.1	Taiwan	5.8	Germany	5.1
Italy	9.0	England	5.1	Netherlands	4.1
Netherlands	8.3	South Korea	3.5	France	3.4
Belgium	6.4	Italy	3.4	South Korea	3.3
Sweden	4.2	France	3.2	Australia	3.0
Switzerland	3.6	Hong Kong	2.9	Belgium	2.8
TOTAL	100.0	Brazil	2.6	Taiwan	2.6
		Singapore	1.4	Italy	2.6
		Netherlands	1.4	Saudi Arabia	2.5
		Sweden	1.4	China	2.2
		China	1.4	Singapore	1.9
		Switzerland	1.2	Venezuela	1.9
		Belgium	1.2	Brazil	1.8
		Australia	1.0	Hong Kong	1.6
		Spain	0.9	Israel	1.4
		India	0.8	Spain	1.4
		Malaysia	0.8	Egypt	1.3
		Philippines	0.8	Switzerland	1.3
		Israel	0.7	Sweden	1.1
		S. Africa	0.7	India	0.9
		Denmark	0.6	Malaysia	0.9
		TOTAL	100.0	TOTAL	100.0

Note:
1. FRB: Multilateral average trade shares, 1972-76.
2. Imports: Merchandise import shares, 1985. These 25 countries are 85% of total U.S. imports.
3. Exports: Merchandise export shares, 1985. These 25 countries are 84% of total U.S. exports.

TRADE-WEIGHTED DOLLAR

	FRB Weights	Import Weights	Export Weights
Annual 1980 - February 1985	+81.0	+83.7	+92.0
February 1985 - June 1986	-28.1	-7.1	-2.3

Note: Percent change in the dollar using FRB trade weights, import weights by country of origin, and export weights by country of destination.)

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Exhibit C

Economic Assumptions of the Presidents: Real GNP (% Change)

Calendar Years

Date & Source	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
2/75 Ford	-3.3	4.8	5.6	6.5	6.5	6.5											
1/76 Ford		6.2	5.7	3.9	6.5	6.5	4.9										
1/77 Ford			5.2	5.1	5.9	5.5	3.9	3.5									
1/78 Carter				4.7	4.8	4.8	5.0	4.7	4.2								
1/79 Carter					3.3	2.5	4.2	4.7	4.4	3.4							
1/80 Carter						-0.6	1.7	4.3	5.0	4.9	4.7						
1/81 Carter							0.9	3.5	3.5	3.7	3.7	3.7					
2/82 Reagan								0.2	5.2	5.0	4.7	4.4	4.3				
1/83 Reagan									1.4	3.9	4.0	4.0	4.0	4.0			
2/84 Reagan										5.3	4.1	4.0	4.0	4.0	3.9		
2/85 Reagan											3.9	4.0	4.0	4.0	3.9	3.6	
2/86 Reagan												3.4	4.0	4.0	3.9	3.6	3.6
Actual	-1.2	5.4	5.5	5.0	2.8	-0.3	2.5	-2.1	3.7	6.8	2.3						

Sources: Budget of the U.S. Government, various years.

Note: Reading across any row shows the assumption of a particular president made on the specified date for the next six years.

Reading down any column shows the various growth assumptions for a particular year made over a space of six years.

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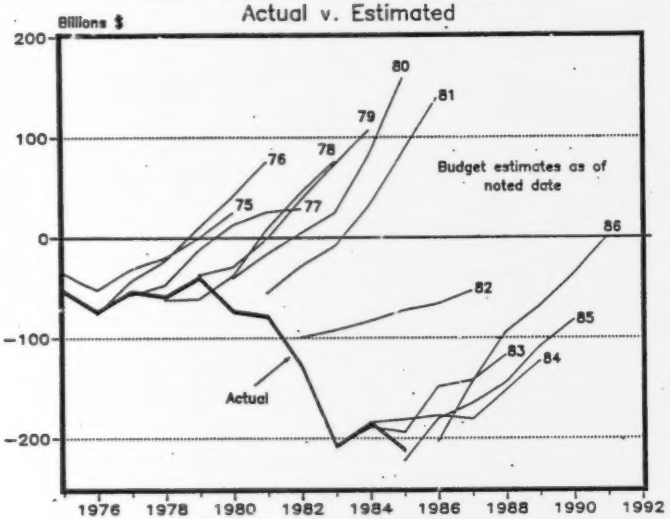
Exhibit D

BUDGET ESTIMATES OF THE PRESIDENTS

Actual v. Estimated



SOURCE: Budget of the U.S. Government, various years.

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The Honorable William H. Gray, III
Testimony Before the Committee on Government Operations
July 24, 1986

I appreciate Chairman Brooks inviting me to testify before the Committee on Government Operations on the impact of the recent Supreme Court decision on Gramm-Rudman.

Automatic Sequestration Versus the Fall-Back Procedures

As you know, I voted against Gramm-Rudman last year. I believed then, as I do now, that Congress is elected to decide which programs are worthy of funding and which are not. The automatic sequestration process that was at the heart of Gramm-Rudman represents to me an abdication of congressional responsibility and accountability: it took a "look, no hands" approach to making hard budget choices.

In contrast, the fall-back procedure that requires Congress to vote on budget cuts, as we did in reaffirming the 1986 sequestration last week, forces us back into reality: we must take responsibility after all. No philosopher king, grand executioner, or fairy godmother can stand in for us.

I believe that Members of Congress should see and feel the consequences of their decisions. For this reason, I tend to find the fall-back position more appropriate than an automatic triggering mechanism that tempts us to hide behind a subterfuge and abdicate Congressional decision-making. It leaves much to be desired in terms of setting priorities--which is why Gramm-Rudman is fundamentally a bad law--but it at least makes us accountable for our actions.

Indeed, I have serious concerns about the Gramm-Rudman "fixes" that the bill's original sponsors are now proposing in "Gramm-Rudman-Hollings II". They would have the OMB Director replace the Comptroller General as the ultimate grand executioner and fairy godmother. OMB and CBO would estimate the deficit and compute any required cuts, which would be reviewed by the Comptroller General, as under the original law. The Comptroller General, then, would forward it to OMB for a final determination. One sponsor has said that OMB's function would be "just a green-eyeshade calculation". Another has noted that OMB would inevitably have some discretion in projecting the deficit and allocating cuts.

The role of OMB is critical. If OMB's role is purely ministerial, the constitutionality of the law could be questioned on the same grounds on which it was successfully challenged--the role of GAO in executing the law. If, however, OMB is not just making a "green-eyeshade" calculation, then we need to be concerned about the accuracy of the estimates and, especially, the direction of its policies. Past performance does not augur well. Recall the "rosy scenario" of 1981 or, more recently, the $10 billion "mistake" in estimating defense outlays for fiscal year 1987. Does Congress really wish to give more power to an administration that apparently cares little about

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reducing the deficit and brought us $200 billion "deficits as far as the eye can see" in the first place?

There are troubling institutional questions here that go to the heart of our system of government. The Wall Street Journal ran an editorial on Monday, July 21, arguing that the logic of an automatic Gramm-Rudman process is leading us inexorably towards the line-item veto. "The emerging consensus", they write, "is that Congress is no longer capable of exercising the power of the purse..., nor does it wish to exercise that power." In their view, when the Gramm-Rudman-Rube Goldberg machine falls apart, the line-item veto "will be the only proposal on the table."

I have no quarrel with the logic of this argument, but I do reject the premise--that Congress cannot do what it was elected to do. Congress can and should exercise its constitutional powers with respect to fiscal policy. If we do not, those powers will be exercised by others--in the executive branch. As the Journal notes, the logic of an automatic Gramm-Rudman law is the logic of the line-item veto, the logic of a transfer of power from Congress to the President. I do not favor such a transfer, nor, I believe, do most Members of the Congress. But we need to understand the implications of our actions before we rush forward to embrace a fairy godmother whose charms may rapidly wither after November.

Let me now take a few moments to summarize how Congress has implemented the fall-back procedure for the fiscal year 1986 reductions, the possible actions with respect to fiscal year 1987 sequestration, and some deficit problems which Gramm-Rudman cannot cure.

Current Status of the Triggering Mechanism and the Supreme Court Decision

Section 274(f) of the Balanced Budget and Emergency Deficit Control Act of 1985 provides that, in the event that any of the reporting procedures under that law are invalidated, there is established a Temporary Joint Committee on Deficit Reduction (TJC), consisting of the entire membership of the House and Senate Budget Committees. The temporary committee then becomes the conduit for transmittal of the sequestration report to the President.

As you are aware, when the Supreme Court struck down GAO's role in calculating Gramm-Rudman sequestration figures, the "fallback procedure" was automatically triggered. The fallback procedure: (1) establishes the Temporary Joint Committee on Deficit Reduction, composed of the two Budget Committees and co-chaired by their chairmen; and (2) requires the TJC to report a joint resolution setting forth the contents of the joint OMB/CBO report. If passed by both Houses and signed by the President, the sequestrations become law. The Supreme Court's decision provided that its judgment, restoring monies sequestered in fiscal year 1986, was stayed for a period of not to exceed 60 days in order to permit Congress to implement the fallback provisions of the Act.

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Congressional Action on the Fiscal Year 1986 Cuts

On July 17, 1986, the TJC met to report a joint resolution setting forth the contents of the joint CBO/OMB sequestration report of January 15, 1986. Pursuant to the Gramm-Rudman law, the TJC could not amend the report. However, due to the fact that the CBO/OMB report of January 15 contained some technical errors and conceptual disputes, using the fallback provision in its pure sense would not satisfy Congress' objective of reaffirming fiscal year 1986 sequestration actions. These were resolved by the GAO in its report of January 20.

In order to account for technical changes made by the General Accounting Office report (which served as the basis for the President's February 1 sequestration order) and policy changes affecting sequestration enacted since February 1, a separate measure outside the scope of the TJC's powers had to be considered. The joint House Leadership worked with the Senate Leadership to develop an approach modifying the fallback procedures to take into account the special situation caused by the triggering of the fallback procedures in the middle of the 1986 sequestration cycle. As a result of those discussions, a simple one-sentence statement reaffirming all actions necessary to reinstate the status quo was developed.

On the same day that the TJC reported a resolution fulfilling its duty under Gramm-Rudman, the House adopted H.J. Res. 672, which reaffirmed the President's sequestration order of February 1 (including GAO's technical changes) and measures enacted since February 1, which affected that order. The Senate passed H.J. Res. 672 by a voice vote. This shows that Congress can act quickly in a bipartisan manner when a consensus is reached on how best to address the deficit problem.

Fiscal Year 1987 Process

Due to the District Work Period scheduled to begin on August 15, the timetable for the 1987 sequestration process cannot follow that set forth in the Gramm-Rudman law.

CBO and OMB will take their first snapshot on August 15 to determine if the projected deficit for fiscal year 1987 will exceed the maximum deficit amount of $144 billion by more than $10 billion. Under the Gramm-Rudman timetable, their report will be transmitted to Congress on August 20, but Congress will not be in session to officially receive and refer the report to the TJC. The TJC will officially receive such report on the first day Congress reconvenes. After receipt, the TJC will have five calendar days to report the joint resolution setting forth the contents of the CBO/OMB report and Congress would vote on such joint resolution within five legislative days after it was reported.

It should be noted that a problem with the 1987 report similar to the one for 1986 could arise if there are errors or omissions in the joint report of the Directors. Since amendments are prohibited, either by the TJC or on the floor, any corrections or modifications would have to be addressed through

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other legislative means. This year, we adopted a correcting resolution to the joint resolution to account for technical corrections and modifications.

Assuming the President signs the joint resolution, he would then issue a sequestration order, if any were required, based upon the CBO/OMB report. This would occur after the September 1 date on which the President is to issue his order according to the timetable set forth in the law.

On October 1, the initial order takes effect. By October 5, OMB and CBO issue a revised report to reflect final congressional action. If the revised report projects a fiscal year 1987 deficit in excess of the Gramm-Rudman requirement, the same process described above for the initial order would have to be followed for the final order as well, i.e., TJC action, congressional action, and presidential signature. At that point, the final order, based on the revised report, would be effective.

Under this timetable, the month of September would be set asice for a congressional response to the sequestration order. Gramm-Rudman sets forth procedures for formulation of an alternative congressional deficit reduction plan in the Senate. In essence, the Senate Budget Committee could initiate a mini-reconciliation process in the Senate. The law is silent on House procedures, although it is assumed that a House response could be coordinated through the Leadership and the Budget Committee.

Fixed Deficit Targets in a Changing World

Irrespective of the sequestration procedures we ultimately adopt to deal with the deficit, I want to reiterate the difficulties inherent in budgeting for fixed deficit targets in a changing world.

After months of effort and negotiation, we passed a budget resolution that meets the 1987 deficit target. We did this without any help or leadership from the Reagan administration. Indeed, the administration thwarted congressional efforts to restore greater long-term fiscal balance by raising additional revenues. Our original approach would have reduced the deficit further below the target of $144 billion, affording a larger margin of error when the August 15 CBO/OMB snapshot is taken. However, we could not assume revenues that the President said he would veto, so we adopted a resolution with a deficit of $142.6 billion, just below the target.

However, passage of this resolution does not guarantee that sequestration will not occur. It is important that the reasons for this be understood.

First, the budget resolution is a blueprint of tax and spending decisions, but only a blueprint. The deficit-reduction policies must now be implemented through legislation designed by the appropriate committees, passed by Congress, and signed by the President.

Second, the OMB and CBO spending and deficit projections will depend upon technical factors largely unrelated to congressional spending decisions. For instance, in the last several years annual budget outlays for agricultural

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support policies have exceeded prior estimates by as much as $12 billion, principally as a result of weather and economic conditions, and there are new reports of further overruns of administration estimates. In the current fiscal year, defense outlays are running about $5 billion or more above earlier projections, without any increase in spending authority, simply as a result of the timing of actual spending by the Pentagon. Gramm-Rudman makes no allowance for spending fluctuations of this kind--fluctuations which can raise the deficit projections by billions.

Finally, and most important, the Gramm-Rudman projections are hostages to economic changes that cannot be accurately forecast, let alone controlled. A normal forecasting error of one percent for the economic growth rate can throw off the 1987 revenue and deficit projections by $15-$20 billion; when compounded with inevitable errors in forecasting inflation and interest rates, the potential for error overwhelms any mid-course policy adjustments that would be possible or wise. In this respect, Gramm-Rudman is inherently flawed. It pretends these economic fluctuations don't exist. When I opposed Gramm-Rudman last year, I characterized this as the "Tinker Bell approach" to fiscal policy. Shut your eyes, clap three times, chant the magic deficit targets, and the economy will do your bidding.

As such fiscal fantasies give way to the hard facts of economic life, we may face some tough decisions. Inflation is down sharply from earlier projections. This is good news for the economy and the Nation, but bad news for the budget in the short term, since revenues fall off faster than spending. Economists have been revising down their forecasts of growth in response to a string of indicators of sluggish activity. The Federal Reserve Board in its recent Monetary Policy Report to Congress revised down its growth estimates for 1986 to 2½-3 percent. Previously, it had forecast 3-3½ percent growth, and the administration had projected 4-4½ percent. The preliminary estimate of real GNP growth in the second quarter was a disappointing 1.1 percent, despite lower oil prices and interest rates. This lower growth suggests that the 1987 deficit which CBO and OMB will project in August will be larger than now estimated in the budget resolution.

We may thus be faced with some very difficult choices in the coming months, but in my view that is why we were elected to Congress. The budget process and the legislative process impose clear fiscal policy responsibilities which must be met. Congress has passed a budget which sets overall fiscal policy consistent with Gramm-Rudman. Now, we must implement specific measures consistent with that policy. We should not allow the Gramm-Rudman sequestration procedures to be triggered because of congressional failure to implement the budget resolution.

However, if the budget deficit should rise simply because of low inflation and weakness in the U.S. and world economies--a weakness related to earlier irresponsible U.S. fiscal policies--we need to understand that the problem lies, not in a failed legislative process, but in the make-believe structure of Gramm-Rudman.

Thank you very much, Mr. Chairman. That concludes my testimony.

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
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TESTIMONY OF

CHARLES A. BOWSHER

COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

COMMITTEE ON GOVERNMENT OPERATIONS

HOUSE OF REPRESENTATIVES

ON

THE SUPREME COURT'S RULING IN BOWSHER V. SYNAR

Mr. Chairman and Members of the Committee:

I am pleased to appear before the Committee to discuss the Supreme Court's recent decision in the case of Bowsher v. Synar. As I shall describe, the immediate consequence of that ruling is clear: because the Comptroller General is removable by joint resolution of the Congress, the General Accounting Office may not carry out the budget reduction responsibilities assigned to it under Gramm-Rudman-Hollings. The longer-term consequences for efforts to reduce the federal deficit and for the General Accounting Office depend to a large degree on how the Congress chooses to respond to the decision.

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This Committee is fully aware of the many functions carried out by GAO. Among these are the responsibilities assigned to the agency at its creation. The Budget and Accounting Act of 1921 established GAO, with the Comptroller General as its head, to provide the Congress with an objective assurance that public funds are spent properly. Under the 1921 Act, GAO was given the authority to investigate and report on the use of public funds by the executive departments. In addition, GAO was provided a number of administrative powers previously held by the Comptroller of the Treasury. These include the power to settle all accounts of the government, to supervise the collection of debts owed to the government, and to render binding decisions on questions of payment submitted by disbursing officers and department heads. The 1921 Act also gave the Comptroller General the responsibility of prescribing accounting principles and standards for the federal government.

The drafters of the 1921 Act conferred these powers on GAO because of their desire to ensure that such functions would be carried out by an officer of the government whose impartiality both the Congress and the President could rely upon. For 65 years, GAO has filled that role as the objective overseer of the expenditure of public funds. The success of the original scheme is reflected in the reliance that both the Congress and the agencies place on the thousands of legal decisions, financial audits, and program evaluations conducted by GAO each year. It is also reflected in the expansion of GAO's functions over the

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years. As Chief Justice Burger noted in the majority opinion in Bowsher v. Synar, the Comptroller General has been assigned a variety of new functions since 1921, including the responsibility of bringing suits to require the release of impounded budget authority, membership on the Chrysler Corporation Loan Guarantee Board and the U.S. Railway Association Board of Directors, and the power to consider bid protests under the Competition in Contracting Act.

The drafters of Gramm-Rudman-Hollings also recognized the value of GAO as an impartial decisionmaker, and chose the Comptroller General to hold the all-important trigger mechanism for automatic budget reductions. Although GAO had not sought this new power, years of experience in audit and evaluation made its staff well-equipped to carry out its responsibilities under the act. On January 21, as required by the statute, GAO reported the reductions necessary to meet the fiscal year 1986 deficit target.

The Supreme Court's opinion addressed two principal questions concerning GAO's role under the statute: first, whether it is permissible under the Constitution for an officer of the United States removable by a joint resolution of the Congress to execute the law; and second, whether the role of the Comptroller General under Gramm-Rudman-Hollings constitutes "execution of the law in constitutional terms." The majority opinion, written by Chief Justice Burger, held that the congressional removal power results in control by the Congress

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that is incompatible with the "execution of the law." The Court also determined that the powers exercised by the Comptroller General under Gramm-Rudman-Hollings were in fact "executive" in the constitutional sense of that term. The Court therefore struck down the role of the Comptroller General under the statute. Justice Stevens, in a concurring opinion in which Justice Marshall joined, concluded that the Comptroller General acts as an agent of the Congress, and as such could not be delegated the important powers assigned to him under the act. Two justices, White and Blackmun, issued separate dissenting opinions.

The Supreme Court's decision had the immediate effect of invalidating the fiscal year 1986 budget reductions ordered by the President on the basis of GAO's January 21st report. The Court stayed its judgment for a period not to exceed 60 days, in order to permit the Congress to act under the so-called fallback procedures of the statute. Under those procedures, the Congress approved the fiscal year 1986 reductions on July 17th.

The decision also has the immediate effect of precluding GAO's participation in the fiscal year 1987 Gramm-Rudman-Hollings budget reduction process next month. It has been suggested by some that the Supreme Court's 60-day stay effectively retains all statutory provisions of Gramm-Rudman-Hollings in effect until September 5th, and that the Comptroller General is therefore still required to issue a sequestration report for fiscal year 1987 on August 25th. It is clear to us,

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however, that the stay was intended to give the Congress a sufficient amount of time to deal with the fiscal year 1986 reductions through the legislative process, and was not otherwise intended to extend a statutory scheme considered to be unconstitutional. Consequently, we have no present plans to issue a report on August 25th.

The longer-term effects of the Supreme Court's ruling depend to a large degree on what action the Congress now takes in response. A number of alternatives have been suggested to replace the automatic sequestration mechanism invalidated by the Supreme Court. Several of these would again assign a role to GAO. We are willing to contribute in any way that the Congress sees fit towards the important goal of deficit reduction, although we would not favor any alternative which would interfere with GAO's ability to advise and assist the Congress.

The first alternative available to the Congress, and the one that we prefer, is to retain the procedures currently in effect under the fallback provision of the statute. The existing procedures ensure that the ultimate authority to determine how budgetary resources are reduced is to be exercised by the Congress itself.

Another alternative would be to create an independent board or commission in the Executive Branch to carry out the functions originally assigned to the Comptroller General under the statute. This alternative would clearly avoid the constitutional problems of the original scheme, and could provide some

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degree of assurance of impartiality.

Other alternatives have been suggested which would keep the Comptroller General in the automatic sequestration process, but would essentially make his report advisory to an existing officer of the Executive Branch. If the Congress determines it desireable for GAO to be involved in the process, such proposals are acceptable to us. One of these proposals, however, would also include a provision authorizing the Comptroller General to bring suit to ensure that the President's order complies with the law. After the decision in Bowsher v. Synar, the Comptroller General's authority to bring this type of action is open to constitutional question. The provision also appears to be inconsistent with a statutory scheme designed to place final authority for making budget reductions in the Executive Branch. For these reasons, we would oppose such a provision.

Finally, one alternative would reinstate GAO as the central decisionmaker in Gramm-Rudman-Hollings, by amending the removal provision considered by the Supreme Court to bar his participation in the automatic sequestration process. This approach would amend the 1921 Budget and Accounting Act by providing that the Comptroller General may be removed by the President. The holder of the office would thus no longer be answerable only to the Congress. The Comptroller General would hold the same status as the head of every agency of the Executive Branch, each of whom is removable by the President, either at will or for cause.

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Making the Comptroller General removable by the President would result in a fundamental change in an arrangement that has existed for some 65 years. As I have already indicated, both the Congress and the various agencies have viewed GAO since its establishment under the 1921 Act as an impartial and valuable source of advice and information. The Congress especially has come to rely on GAO as an indispensable aid to its oversight requirements. The great amount of resources that the agency devotes to audit work on behalf of congressional committees, including this committee, testifies to the importance of GAO to the work of the Congress. We would oppose any proposal that might result in a change in that status.

With respect to any proposal to amend the 1921 Act, we are concerned that the Congress, in the rush to find a quick "fix" for Gramm-Rudman-Hollings, may choose an alternative that achieves the unintended result of diminishing GAO's effectiveness. We recognize that the Supreme Court's decision in Bowsher v. Synar may also affect some of the other functions carried out by GAO. In our view, however, legislation addressing the broader implications of the decision for GAO should be considered only after careful study of the Court's opinion. Such legislation should not be included in current efforts to cure the constitutional problems of Gramm-Rudman-Hollings, or be appended to emergency legislation such as that currently required to increase the limit on the public debt. In sum, we believe that any change in GAO's relationship to the Congress

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and to the President should only be undertaken with great caution and full understanding of the consequences, in order to ensure that the result is consistent with the traditional role that the agency has successfully filled since its creation.

That concludes my prepared remarks, Mr. Chairman and Members of the Committee. I would be glad to answer your questions.

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EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

TESTIMONY OF

JAMES C. MILLER III

DIRECTOR

OFFICE OF MANAGEMENT AND BUDGET

before the

GOVERNMENT OPERATIONS COMMITTEE

U.S. HOUSE OF REPRESENTATIVES

on

THE BALANCED BUDGET AND EMERGENCY DEFICIT

CONTROL ACT OF 1985

July 24, 1986

Mr. Chairman and Members of the Committee: I am pleased to appear before you to discuss the Balanced Budget and Emergency Deficit Control Act of 1985, the Gramm-Rudman-Hollings (G-R-H) Act. My testimony today deals with the impact of G-R-H to date and the outlook for the future in light of the recent Supreme Court decision.

In holding that the Comptroller General's role in the Act's sequester process was unconstitutional, the Supreme Court left unaffected the Act's deficit reduction targets. The Administration remains committed to meeting these goals. The Court also stayed its order through September 5th to permit Congress to implement the fallback provisions of the law and to decide whether to affirm the sequestration then in effect for FY 1986. I am very pleased Congress acted promptly in the affirmative, and I anticipate the President's signing the joint resolution as soon as it reaches his desk.

As you know, G-R-H limited the size of the outlay sequester in FY 1986 to $11.7 billion. Under the President's order of last February, non-defense programs subject to sequestration were reduced by 4.3 percent. The across-the-board cut for defense programs was 4.9 percent. In furtherance of the Act's provisions, we issued guidance to the agencies urging them to minimize the impact of the sequester on the civilian workforce and to absorb the cuts in a manner generally consistent with good management practices. Most agencies were able to achieve these goals with little difficulty.

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A number of agencies, including the Department of Defense and the Library of Congress, had difficulty -- in major part because they were cut more by the regular appropriations bills than by the sequester. But such cases were fairly isolated. For example, last May, OMB informally surveyed major agencies to ascertain the likely effects of sequestration on the Federal civilian workforce (including the civilian portion of the Department of Defense). Out of about 2,120,000 in total FTE civilian employment, excluding the Postal Service, G-R-H and other factors were expected to lead to about 5,000 fewer FTE's for the year, with almost all reductions accommodated through attrition; hardly any (less than 100) FTE reductions were expected to be the result of compulsory reductions-in-force (RIFs).

Earlier this month, we undertook another informal survey and found that, with rare exception, the total deductions are now estimated to be considerably lower -- in large measure because of additional funding for key initiatives contained in the recently-enacted Urgent Supplemental. Although the number of RIFs remained the same, the total number of planned furloughs due to G-R-H has declined by 80 percent.

While it now seems clear that agencies were able to absorb the FY 1986 sequester without major disruptions -- not only to personnel but in terms of the services and other benefits provided -- it should be noted that a further sequester for FY 1987 of any magnitude would have much more serious consequences. Thus, the Administration believes it is essential for Congress to enact spending legislation that achieves the $144 billion deficit target for FY 1987 through targeted cuts and reforms without sacrificing our national defense or raising taxes.

Currently we are in the process of updating the Adminstration's budget and plan to issue a revised deficit estimate early next month. However, I should tell you that it is becoming increasingly clear that recent economic developments and other factors have made it more difficult to meet the FY 1987 deficit target than either the Administration or Congress anticipated just a few months ago. On the other hand, we do believe that it is possible to hold the line on the deficit without jeopardizing our national defense capability or raising taxes. The revised deficit estimate based on modifications in the President's budget that we will issue next month will be in accord with the G-R-H target of $144 billion for FY 1987.

Of course, the report just mentioned is the Mid-Session Review, which was due to be released on July 15th. Unfortunately, as in recent years, we were not able to meet the July 15th date. This year there were two major reasons

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for delay. First, we needed to incorporate the effects of the recently-enacted Urgent Supplemental, and it simply wasn't possible to accomplish this in the time provided. Second, as you know, we are experiencing considerable uncertainty right now over the pace and direction of economic activity, so it seemed highly propitious for the Mid-Session Review to reflect the government's second (calendar-year) quarter 1986 preliminary growth figures, due out on July 22nd. Thus, we expect to publish the Mid-Session Review the first of next month.

Now, let me turn my attention to the G-R-H report due on August 20th, and I want to stress at the outset that, by law, it will reflect different assumptions than the Mid-Session Review. Thus, there is every reason to anticipate that its projection of the FY 1987 deficit will be different than the one contained in the Mid-Session Review. I wish to stress this point because I am very sensitive to the confusion that may well be generated when we release two different deficit estimates so close together.

The major assumptions required by the G-R-H report of August 20th are as follows:

-- For receipts, we must assume continuation of current law; excise taxes dedicated to trust funds are assumed extended at current levels.

-- For appropriated programs, we must assume enacted FY 1987 levels. For those accounts where Congress has not enacted full-year appropriations for FY 1987, we must assume a continuation of levels appropriated for FY 1986.

-- For programs that are not appropriated, such as social security and offsetting receipts, we must assume continuation of current law.

These rules, then, are used to develop what is known as the "Gradison-baseline," after Congressman Bill Gradison, who sponsored this solution to problems attendant with forecasting likely Congressional action on receipts and appropriations.

As you know, under G-R-H our report of August 20th is submitted along with a similar report by the Congressional Budget Office (CBO). Not surprisingly, because so many conceptual issues have to be resolved in applying the Gradison baseline, there may well be slight differences between the two agencies. In principle, we tend to read the Act as written whereas CBO tends more towards gleaning the Act's intent. Nevertheless, it is my hope that we can resolve all the conceptual differences before the joint report is published on August 20th.

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In all likelihood, both OMB and CBO will conclude in their reports of August 20th that the FY 1987 deficit will exceed $154 billion, thus indicating that a sequester will be necessary unless Congress acts. Then, of course, OMB and CBO will submit another joint report on October 6th, reflecting the same baseline rules but also reflecting any interim Congressional action that affects the deficit.

Let me address one final issue. Senators Gramm, Rudman and Hollings have proposed to amend G-R-H by placing ultimate responsibility for the estimates with the Director of the Office of Management and Budget. Specifically, their proposal would continue to have OMB and CBO report to GAO. But rather than have GAO issue the final report to the President, GAO would now report to OMB. OMB would then report to the President and to Congress, and the Presidential order would be based on the final OMB report.

We support efforts to improve G-R-H. The promise this law made to the American people must be fullfilled.

As we understand the proposed amendment, it would correct the constitutional problem the Supreme Court found. The final report would be issued by an official serving at the pleasure of the President, the Director of OMB. Moreover, the Director would not be legally required to use legislative branch numbers in his final report, either by averaging or otherwise. However, he or she would be subject to the same constraints the Comptroller General was under in the original version of G-R-H.

Mr. Chairman and Members of the Committee: that completes my statement. Now I shall be happy to address your questions.

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